

May 3, 2005

**Minutes Of The Meeting Of The
Treasury Borrowing Advisory Committee
Of The Bond Market Association
May 3, 2005**

The Committee convened in closed session at the Hay-Adams Hotel at 3 p.m. All members of the Committee were present. Assistant Secretary for Financial Markets Timothy Bitsberger welcomed the Committee and gave them the charge.

The Committee addressed the first question in the Committee charge (attached) on what characteristics of Treasury's liability portfolio are most salient, including the average maturity of debt, steady state issuance, and rollover. A Committee member presented a series of charts on this topic (attached) showing that current issuance patterns lead to a growing proportion of TIPS and 5-year notes in the portfolio and that the percentage of debt maturing in 3 years or less was expected to remain stable at around 60 percent.

The Committee member noted that rollover risk did not appear high compared to the last 25 years but, absent changes in coupon sizes, bill issuance would need to increase markedly in 2008. The member observed that Treasury may need to decide if more long-term issuance was warranted. The Committee member indicated that under the central forecast, there was no need for strategic changes until bills begin to become a sizable portion of issuance in 2008. However, noting that the market's consensus forecast was biased toward a pessimistic scenario, the member observed that there may be a need to make a decision to change financing sooner, perhaps in 2007 or even 2006. The member suggested that the nature of Treasury's rollover risk was related to refinancing at less attractive terms, as opposed to not having market access.

The Committee member briefly reviewed Treasury's debt management efforts to meet its objective of lowest cost borrowing over time by issuing debt in a regular and predictable pattern, engaging with the market in transparent fashion, and not attempting to time markets. The Committee member concluded that Treasury's portfolio appears to be well balanced, meeting Treasury's objectives and providing flexibility for most possible financing outcomes. The Committee member did note that there was an asymmetric risk profile, noting that higher unexpected borrowing needs would force a change in issuance before lower borrowing needs would.

Continuing the discussion on overall demand for Treasuries, the Committee member noted that the yield curve has flattened recently, largely driven by anecdotal stories of pension fund demand and speculative accounts trading on those anecdotes. The Committee member questioned whether the demand for long-term issuance was temporal or persistent, and cautioned about reacting to short-term changes in the market. Noting that the liquidity for 30-year futures contracts was still low relative to the intermediate sector, the member suggested that sustainable long term demand was not there yet.

The Committee member also noted that demand for Treasuries is being driven by developments in other sectors of the fixed income universe, including the mortgage market. One member stated that adjustable rate mortgages (ARM) are currently 36 percent of new origination, creating significantly more hedging demand in the intermediate sector of the Treasury curve.

Turning to foreign demand, one Committee member noted that foreign participation in primary and secondary markets can be unpredictable and that Treasury should take a longer-term view towards foreign demand -- not a one or two year perspective but a decade long view. The member noted that foreign participation will change over time but that Treasury should not change its policy based on high concentrations of its largest three or four foreign buyers.

One Committee member recommended efforts to improve collection of data on foreign participation in the primary and secondary markets and analysis of long-term trends in foreign demand. The Committee member also noted that traditional metrics of auction performance, the bid/cover ratio and market tail, are not very helpful in explaining auction outcomes relative to issue size. In response to the observation on the quality of metrics, one member suggested that the Treasury should consider conducting annual surveys to ascertain the holders of Treasuries. The member thought this would provide a better measure of sources of demand for Treasuries.

Next the Committee turned to the second question of whether there are any market trends of significance to Treasury as an issuer. A Committee member presented a series of charts on this topic (attached). The Committee member noted several trends -- an imbalance between long duration supply and demand, foreign demand for Treasury debt, and growth of the credit derivatives market.

Regarding long-duration supply and demand, the Committee member noted that pension fund dynamics in the face of pending reform argue for a potential shift in asset-liability management which could increase demand for long-term securities. Demand for long-term assets has out-paced demand for intermediate term assets but that much of this demand has been speculative in nature as hedge funds and speculative accounts have tried to get ahead of the curve on pension reform.

The Committee member noted that some recent figures suggest that pension plans are currently under-funded by \$450 billion and that if pension reforms pass there will likely be greater demand for long-term assets. However, another member noted that the process for introduction of pension reforms is expected to be a seven-year process and that there is significant time for Treasury to assess the market before bringing a long-term instrument.

The presenting Committee member noted a flattening of the 10s-30s curve since the Labor Department released a proposal for reform of defined benefit pension funding rules. The Committee member also noted that the increase in ARM origination has

shortened the duration of mortgage assets and agency outstanding securities, further decreasing longer-duration supply. While increased issuance of long-dated TIPS was noted, the Committee member observed that the TIPS market remains illiquid relative to the nominal Treasury market and was not seen as a viable alternative for long-dated nominal securities until the TIPS market matured further. The member stated that high levels of investor concentration in the TIPS market posed risks of substantial dislocations should changes in investment strategy occur.

The Committee member then presented a chart assessing the possible borrowing costs of using a duration weighted combination of 2- and 30-year bonds in place of 5-year issuance. On a historical basis, it was noted that such a strategy would have reduced interest costs in recent years, but the current attractiveness of such a strategy is small.

Turning to foreign participation in Treasury auctions, the Committee member noted that changes in China's exchange rate management could reduce China and other Asian official purchases of Treasuries. The Committee member suggested that reduced official purchases would exert upward pressure on Treasury rates which could be magnified by dollar weakness, increasing Treasury's borrowing costs. Despite these potential concerns, the Committee member noted that overall foreign purchases remain robust.

Finally, the Committee member noted that trading volume and notional outstanding in credit derivative markets had doubled over the last two years. The Committee member noted that in the context of a slowing economy and rising interest rates it was possible that credit quality could deteriorate in the coming quarters. The Committee member noted it was difficult to assess whether credit derivative markets would function well if faced with a major credit event.

Next, Assistant Secretary Bitsberger turned to the third question of the charge: whether Treasury should consider the reintroduction of a 30-year nominal bond. Assistant Secretary Bitsberger presented a series of charts on this topic. Assistant Secretary Bitsberger stated that Treasury's primary objective of lowest cost financing over time requires issuance diversification. Such diversification widens Treasury's investor base, provides flexibility in financing, lowers operational and event risk and facilitates efficient cash management.

Next Assistant Secretary Bitsberger discussed questions that Treasury would consider regarding possible long-dated issuance. The questions were what is the optimal level of diversification, can bond issuance be undertaken within Treasury's commitment to a short-dated bias and do future financing needs and market conditions provide a rationale for bond reintroduction.

Assistant Secretary Bitsberger then presented a chart showing the impact of bond issuance on the percentage of debt maturing in upcoming years, the consequences of bond issuance on the distribution of debt outstanding by security, an average maturity chart with and without hypothetical bond issuance, an illustration of the implications of

bond issuance on average changes in auction sizes, and an interest cost comparison between a portfolio with and without bonds.

One Committee member led off the discussion noting that based on the presentation he felt better about the average maturity of Treasury's portfolio including bonds. He noted that Treasury had issued bonds before and that Treasury presently is one of the few in the G-7 that does not issue a 30-year instrument. The member also expressed the view that additional Treasury supply in the sector could facilitate the work of the Federal Reserve.

Another Committee member noted the flattening of the yield curve suggested long-dated issuance made sense. However, a third Committee member observed that the chart in the Committee's presentation on assessing the possible borrowing costs of using a duration weighted combination of 2- and 30-year bonds in place of 5-year issuance suggested that the time for Treasury to have issued 30-years was several years ago, not now. This member queried what had changed since 2001 or even two years ago to cause Treasury to reconsider long-dated issuance. The member observed that the yield curve had been extremely flat when Treasury had discontinued the bond. He also observed the recent strength in tax receipts and questioned as to whether it made sense for Treasury to contemplate reintroduction when deficits appeared to have peaked.

Another member noted that Treasury needed to take a long-term perspective when making decisions and emphasized the importance of not reacting to short-term trends. In response, Assistant Secretary Bitsberger noted that Treasury was assessing possible structural changes related to pension reform.

One Committee member noted that pension demand had been identified by the Committee before as a reason to maintain 30-year issuance but that Treasury had argued that such demand could be met by the swaps market.

Another Committee member observed that given the expectation of continuing budget deficits it made sense for Treasury to increase issuance further out the curve to reduce risk. However, this member questioned whether increased 5- and 10-year issuance might be preferable to resumed 30-year issuance. This member noted greater liquidity in these maturity points as well as greater futures activity in the intermediate portion of the curve as illustrated in the Committee's presentation on market trends. The member observed that a small program, of say \$10 billion in semi-annual auctions of 30-year securities, could prove insufficient to revive liquidity in the long-end of the Treasury curve.

Assistant Secretary Bitsberger noted for the Committee that the two options Treasury was contemplating were either no reintroduction or semi-annual issuance of \$20-\$30 billion beginning in February. One Committee member observed that while issuance of \$20-\$30 billion would entail little loss of flexibility for Treasury that perhaps this level of issuance did not go far enough in terms of increasing average maturity.

Assistant Secretary Bitsberger asked whether Treasury's consideration of reintroduction of the 30-year was consistent with Treasury's policy of regular and predictable issuance. One Committee member observed that Treasury was unlikely to face buyback pressures in the medium-term. Another member felt it was important that if Treasury was to reintroduce the 30-year that it explain clearly why reintroduction made sense. This member stated that an abrupt change in policy would reflect poorly on Treasury's credibility and that Treasury should take time to consider reintroduction. This member also echoed the observation of other members that a modest benchmark 30-year did not dramatically impact average maturity.

This comment prompted several Committee members to question if Treasury sought to change the average maturity of its debt whether the 30-year was the best way to achieve that. The Chair reminded members that the charge specifically asked the Committee for advice about a nominal 30-year bond.

Assistant Secretary Bitsberger noted that Treasury had purposefully elected to talk about 30-year securities so as to put some parameters on the discussion. A Committee member noted that given budget deficits, Treasury should not let the average maturity of its debt fall further and should increase the duration of its issuance, which might include increasing issuance in coupons as well as reintroduction of the 30-year. Another Committee member observed that focusing on the 30-year sector as opposed to discussing possible 20-year or 50-year issuance made sense given that the 30-year had been a prior issuance point and that there remained a futures contract for the instrument.

Finally, the Committee discussed its borrowing recommendations for the May refunding and the remaining financing for this quarter as well as the July-September quarter. Charts containing the Committee's recommendations are attached.

The meeting adjourned at 4:42 p.m.

The Committee reconvened at the Hay-Adams Hotel at 6:45 p.m. All members of the Committee were present. The Chairman presented the Committee report to Assistant Secretary Bitsberger. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 7:00 p.m.

Jeff Huther
Director
Office of Debt Management
May 3, 2005

Certified by:

Ian Banwell, Chairman
Treasury Borrowing Advisory Committee
of The Bond Market Association
May 3, 2005

Attachments:

<http://www.treas.gov/offices/domestic-finance/debt-management/adv-com/minutes/mm-2005-q2.pdf>

**Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – May 3, 2005**

Treasury's Public Debt Portfolio

Please discuss the characteristics of Treasury liability portfolio including average maturity of debt, steady state issuance, and rollover. Do these metrics adequately capture Treasury's policy concerns? Are there other metrics that we should be using to develop debt management policies?

Demand for Treasuries

Please describe any trends in the Treasury market that you believe are significant to Treasury as an issuer.

Nominal Long-Dated Debt

Should Treasury consider reintroducing regular 30-year bond issuance?

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately \$40 billion of privately held notes and bonds maturing on May 15, 2005.
- The composition of Treasury marketable financing for the remainder of the April–June quarter, including cash management bills.
- The composition of Treasury marketable financing for the July – September quarter.